

Rendezvous With Auld Lang Syne

The decade of the dreadful “Naughties” (2000-2009) is over, thank goodness, and the start of a new decade is upon us. “Auld Lang Syne” is a familiar Scottish hymn sung worldwide at the stroke of midnight to welcome the New Year. It literally translates to “old long ago” or simply “the good old days.” Coinciding with this turn of the decade, we believe, is a *Rendezvous with the Good Old Days* as a synchronized global recovery is exposed. Belief in the *New Normal* we expect to give way to the *Good Old Days* of a more normal recovery. Economic recovery has been accelerating since March 2009, but even if real growth peaks below the historical average of 6-8% for such a steep recession, 2010 will likely feel better than consensus forecasts suggest.

This time of year one might be deluged with pithy versions of “Fearless Forecasts” and “Top-10 Unlikely Surprises for the Coming Year”. We do think that it is helpful to stress test our assumptions and consider improbable outcomes that could be harmful to investor returns. On the other hand, we shared 10 *popular theories* in December’s Investment Highlights that we believe are unlikely to play out as expected and could diminish investment returns. With such a high level of uncertainty so pervasive, investors are keen to know what might drive a return to normal growth. In this Outlook, we articulate some of our most compelling insights for the coming year, and their most likely impact.

Most investors agree that the last two years have been extraordinary, in many respects. Uncertainty, measured by market volatility, reached unprecedented levels last March. Although price volatility has since normalized, variability of economic statistics is still rising, and we observe a wide dispersion between forecasts globally. A return to the good old days and previous highs in the stock market will hinge on earnings growth. HighMark’s earnings growth expectations exceed 61% for 2010-2011. The economy likely contracted for 10 months between September 2008 and June 2009, resulting in a 2.7% decline in nominal GDP. It felt worse than this however and many families are still suffering.

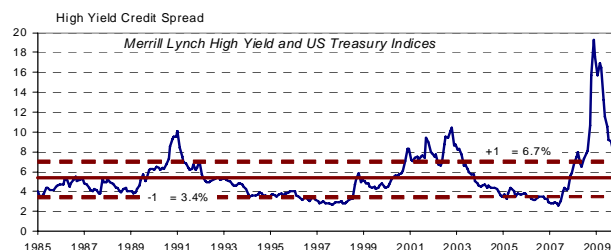
We believe that an important 2010 theme will be the increasing visibility of a global synchronized recovery. Global growth exceeding consensus forecasts could drive earnings even higher, providing a *Rendezvous With Auld Lang Syne*. The best evidence in the U.S. has been the improvement of our favorite leading indicator, namely the Institute of Supply Management Survey.

Emerging Market growth also accelerated, including China’s stronger than expected fourth quarter report of 10.7% real growth. These trends should necessitate monetary and interest rate tightening sooner and to a greater extent than expected. A dramatic “V” pattern is evident in most economic statistics now. Our research into previous “W” cycles revealed that each period was actually characterized by two independent “V” periods with a misguided policy change or other shock on the heels of the first recovery. Protectionism, tax hikes or aggressive rate hikes are some typical causes.

Investment Performance Review

Given strong earnings reported for the third quarter and the acceleration observed in global economic conditions, the S&P 500 chalked up its third strong quarter in a row, tacking on 6.0% to push the 2009 return to 26.5%. Since the S&P 500 troughed March 6th, the index returned over 67%, plus dividends. Technology stocks continued to run, boosting the total return of 61.7% for the year by 10.7% during the fourth quarter. Strong performance of the NASDAQ Composite (+46.5%) reinforced the outperformance of Growth vs. Value in 2009. Strong performance of the small-cap Russell 2000 in December (+8.0%) evened up the differential between large and small-cap stocks. Meanwhile, the +6.0% outperformance of international stocks in MSCI EAFE can be largely attributed to the decline in the US dollar (-5.7%) in 2009.

Barclays Capital Aggregate Bond Index returned +5.9% for the year. Given “toxic” credit asset concerns, it is remarkable that high yield bonds performed so well, tacking on 5.8% in the fourth quarter to return 56.3% in 2009. Credit spreads tightened from a peak of 21% to 6%. Liquidity has improved and credit prices better reflect their intrinsic value as the effects of FAS #157 begin to reverse. Credit asset “write-ups” have bolstered financial sector earnings, but banks will recognize little benefit this year, mindful of anti-Wall Street sentiment.



Source: HighMark Capital and Thomson Datastream

Treasury bonds had the worst post-war year as fiscal deficits soared and the economy firmed. Quantitative easing, or buying government debt, didn't forestall an increase in 10-yr Treasury yields from 2.2% to 3.8% in 2009, resulting in a -9.4% loss. Long bonds fell -25.6%.

The Commodities Research Bureau index rebounded +33.4% following 2008's dismal performance (-23.7%). Oil prices increased 80.4% to \$79.36, while gold closed at \$1096. Both of these commodities seem extended. Taking account of excess oil inventories and production cuts that should free up capacity, oil would probably be trading lower if not for OPEC's stated desire to keep prices above \$70. For gold, we can draw a comparison to the peak in September 1980 and subsequent 50% decline by March 1982. After peaking over \$1200, investors should be cautious of a \$600-800 downside if the U.S. dollar begins to appreciate, as we expect.

Tactical model recommendations of HighMark's Asset Allocation Committee (AAC) took advantage of many investment opportunities in 2009, adding 1.75% vs. our 60% equity/35% bond benchmark. Similarly, HighMark's Growth & Income Allocation Fund (A-share), run with wider ranges and tactical breadth, outperformed by 5.8% vs. a similar benchmark net of expenses, following a challenging year in 2008. Our overweight to equities and underweight to bonds, plus tilts toward high yield bonds, emerging market equities, small-cap stocks, and a timely rotation from growth into value added to excess returns.

Big Ideas for 2010

Every New Year is a time of reflection, as much as it is a time to look forward and ask critical questions. Behind the strengthening global recovery, we highlight several output gaps in economic activity that upon normalizing, should promote U.S. activity: (1) *Deferred capital investment*, (2) *Inventory destocking*, (3) *Net export deficit (ex-oil)*, (4) *New housing starts deficit*, and (5) *Pent-up consumption demand*. These output gaps should rebound more quickly than during a typical recession, given a powerful combination of lowering interest rates and monetary stimulus, plus high productivity and profit margins. Our big ideas for 2010 include reversing the five output gaps above, as well as:

- Global recovery necessitates monetary and interest rate tightening sooner and to a greater extent than expected.
- Fading risk intolerance bolsters acquisition activity, stock offerings, equity fund inflows, and U.S. capital flows.
- Gold and oil prices undermined by U.S. dollar appreciation, rising interest rates, and unwinding of monetary stimulus.
- High productivity and firm profit margins result in continued positive earnings surprises.
- Substantial increase in household net worth.
- Housing starts double by the end of 2011, bolstering job growth and domestic consumption.
- Emerging markets continue to decouple and mature.
- Loss of the Senate supermajority and approaching midterm election is likely to further legislative gridlock, support greater fiscal restraint, and require more financial reform, therefore reducing policy uncertainty about future economic growth.

Economic Outlook

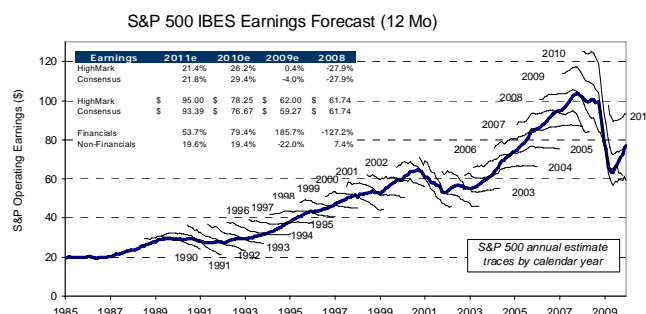
The global economy is expanding again and even appears to be accelerating. Many leading business and consumer sentiment indicators have been improving for several quarters but now, mid-cycle variables, such as industrial production, capacity utilization, and retail sales are accelerating. The pace of the U.S. recovery has exceeded even our expectations, suggesting to us that the recession ended in June 2009. Fourth quarter 2009 real growth is expected to be even stronger than the third. Given the potential significance of the five U.S. growth drivers highlighted above, we believe upside risk is increasing to our above consensus 3.0% economic growth rate in 2010. Our long-term potential growth expectation remains at 2.7-3.0%, but we expect higher growth if fundamentals improve further.

Economic Forecasts	2006	2007	2008	2009e	2010e	2011e
U.S. GDP (Real)	2.8	2.0	1.1	-0.9	3.0	3.0
Earnings Growth	15.3	-1.6	-27.9	0.4	26.2	21.4
CPI Inflation	2.1	4.4	-0.2	1.0	2.0	2.5
Unemployment	4.6	4.6	7.2	10.0	9.4	8.5
Fed Funds Target	5.25	4.25	0.25	0.25	1.75	3.25
Treasury Notes-10y	4.71	4.03	2.25	3.84	4.50	5.00

Source: HighMark Capital estimates and Thomson Datastream

Despite the collective fears and skepticism of many, concerns are waning. Global growth appears sustainable and capital market liquidity is improving. Risks of adverse policy changes that might undermine the economy have diminished. Political gridlock on all major policy initiatives is likely given fast approaching midterm elections and the Massachusetts Senate election result.

Earnings ultimately drive stock markets. Companies began to pre-announce upside earnings surprises in March 2009, which caused a reversal in stock indices. S&P 500 earnings are expected to increase 63% over the next two years, according to consensus forecasts. In Q3 of 2009, Thomson reported that 79% of companies beat earnings estimates, the highest percentage ever. Reports for Q4 of 2009 are nearly as strong so far with 78% of companies exceeding expectations compared to a historical average since 1994 of 61%.

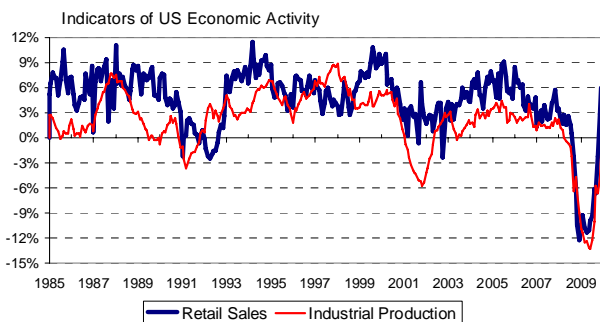


Source: HighMark Capital and Thomson Datastream

Earnings growth expectations for 2010 suggest some interesting sector perspectives. Technology earnings are expected to jump 24%, but that will appear modest versus increases in Materials (73%), Energy (47%), and

Consumer Discretionary (28%). Financial earnings estimates increased 156% in 2009 and should extend gains another 162% in 2010. In contrast to the strong cyclical recovery in earnings, Health Care, Consumer Staples, Telecommunications, and Utilities will lag. While much of this may well be discounted, we believe the greatest potential for upside surprise is in the Industrial sector with significant international exposure and dramatic cost rationalization.

Investors should distinguish between the Fed's belief that current conditions "warrant an exceptionally low federal funds rate for an extended period" and the inference that rates will not increase in 2010. Interest rates of 2% would still be exceptionally low even if inflation exceeded 1%. CPI inflation increased 2.8% in 2009, while commodity prices rose 33.4% and weekly wages rose 1.9%. It is unlikely that the Fed can justify endangering price stability, if inflation is increasing and the economy is expanding faster than 2%. We expect that the Fed will raise interest rates sooner than expected, likely before mid-year.



Source: HighMark Capital and Thomson Datastream

Congress increased the debt ceiling \$280 billion on Christmas Eve and has proposed upping it another \$1.9 trillion to \$14.3 trillion, a total increase greater than the combined GDP of Spain and Ireland and equivalent to 100% of U.S. GDP. Meanwhile, the average maturity of U.S. Treasuries has fallen to four years, a 50 year low. These obligations commit taxpayers to huge liabilities that will compound at higher rates when interest rates rise. The interest expense on \$12 trillion is over \$200 billion/year, and the White House estimates that our interest expense should exceed \$700 billion per year by 2019. The fiscal debt is expected to increase another \$1.6 trillion in 2010 vs. a deficit of \$178 billion in 2007 and \$190 billion in 2008. We are concerned about what measures will be proposed to reduce the deficit.

The Banking System

Crisis driven monetary stimulus and interest rate cuts were designed to increase liquidity and credit, while limiting taxpayers cost by being structured as preferred equity, loans and guarantees. Distressed credit prices have recovered, as liquidity and the economy improved, adding to bank earnings and bolstering capital. Federal regulators have struggled to keep pace with financial innovation and rising complexity over the last 15 years. It

took a financial crisis to expose fraud, manipulation, and other enforcement weaknesses and meager consumer lending oversight. The challenge will be significant modernizing of our financial regulatory structure.

The Federal Reserve is the most visible bank regulator, but it only directly regulates state chartered banks and bank holding companies. The Office of Thrift Supervision oversees Federal Savings Banks, while the Office of the Comptroller of the Currency (OCC) oversees regulation of the national banking system. Credit Unions and state chartered insurance companies are responsible to their own regulators, while the Federal Deposit Insurance Corporation has its own regulatory powers over most banks. The SEC oversees securities trading, but not derivatives. While the CFTC regulates most derivatives, nobody was regulating the nominal \$40 trillion of credit default swaps (source of AIG bailout). It is apparent that financial regulation is overly complex, fragmented, and inconsistent, resulting in considerable gaps in oversight.

Financial reform should begin with consolidation into a single banking regulator (Federal Reserve) and securities regulator (SEC). All other regulators could become branches or departments of either of these regulators, thereby streamlining functions, reducing costs and increasing oversight effectiveness. We believe consolidation would close regulatory gaps, increase consistency, adapt to innovation more effectively, and improve enforcement. Multi-regulated firms would benefit from reducing redundant compliance and operational costs. Lower regulatory costs and efficiency would help lower fees. We are not optimistic that introducing another regulator, such as the Consumer Protection Agency, would head off a financial crisis, but think it could increase costs and impede competitiveness.

Deterioration of subprime loans helped trigger the financial crisis, but would it be surprising to know that most subprime originators operated outside the banking system? Most subprime agents have gone bankrupt, closed, or were taken over by other banks. The Center for Public Integrity Research compiled a list of the top originators of subprime loans between: 2005-2007. Five of the top seven subprime originators were non-bank mortgage companies, including: Countrywide Financial (\$97.2B), Ameriquest Mortgage (\$80.6B), New Century (\$75.9B), Option One Mortgage (\$64.7B) and Fremont Investment & Loan (\$61.7B). They accounted for \$380 billion of \$1,380 billion or 27.5% of subprime origination. The top-25 subprime lenders provided 72% of subprime, but 17 were not regulated banks, nor permitted to gather deposits, so they securitized every mortgage. The failure to bring non-bank finance companies under a consistent regulatory regime promoted unfair advantages and fostered systemic risk. If 21 of the top-25 subprime lenders no longer exist, should the surviving banks shoulder the blame for the crisis?

Given the complexity and significance of what was needed to restore confidence in financial markets, it is not surprising that those resentful have confused the

soaring fiscal cost of an ineffective \$787 billion stimulus with the monetary efforts of the Federal Reserve and Treasury, which helped restore liquidity. Many larger banks did not want or need TARP loans collateralized by non-voting preferred shares given the high cost of warrants and a 5% dividend. Some claim they were persuaded to accept the loans to minimize the stigma for those that needed it. Other financing and liquidity programs helped replace a plunge in securitization and critical commercial paper issuance. Of \$245 billion in TARP loans to banks, \$185 billion or 75% has been repaid. Treasury has collected over \$17 billion in dividends, plus warrant settlements.

TARP preferred share issuance was structured to avoid any perception of bank nationalization or operating control. This intent has been disregarded by directing company leadership changes and hiring a Pay Czar. An unfortunate consequence of these actions is that it limits future policy options. Strong earnings, improving credit asset values, and share issuance have helped rebuild bank capital at a high cost to shareholders. TARP loans to banks and all the other liquidity programs may even result in a gain for taxpayers. Yet, a proposed tax on large banks to cover TARP losses seems to ignore the fact that remaining TARP liabilities are dominated by AIG (\$127B), Fannie Mae (\$60B), Freddie Mac (\$51B), automakers (\$75B), and small regional banks. Attempts to redirect repaid TARP loans are also troubling.

Attempts to regulate bank compensation globally may have unintended consequences. Flexible compensation plans helped banks weather the financial crisis by reducing costs when needed most. Government directed compensation changes have reduced financial flexibility and put these companies at a retention disadvantage. Gordon Brown's misguided desire to tax 50% of bank bonuses is already having adverse consequences in the U.K. U.S. taxpayers hold a large share of companies

where government is intervening. Past policy responses to previous crises gave rise to decisions that had adverse consequences and interfered with free markets.

Conclusion

We have questioned the *New Normal* of much lower potential growth and "subordination of the equity risk premium" since the spring 2009, but this hypothesis is deep in the hole already. A more likely scenario to us looks like a *Rendezvous With Auld Lang Syne*. Conditions favor stocks outperforming bonds by a wide margin. HighMark revised down our long-term return forecast for bonds in mid-2009, which increased our equity risk premium forecast to 4.4%, versus a normal level of 3%. These unpleasant presumptions don't have to be America's destiny, and many are finally questioning their validity. Many changes in behavior should be expected following such a severe financial crisis, but skepticism and hopelessness will fade once signs of recovery are indisputable. Assuming "it's different this time" never works out well.

We believe that global growth can exceed consensus forecasts and will be difficult to derail for the foreseeable future. We do need to identify new growth engines of innovation that can carry us through the next cycle. America has durable competitive advantages, including its engine of innovation, and has proven its resilience once again. The Fed will have to respond sooner and more aggressively with interest rate hikes than many anticipate. Conditions favor stocks outperforming bonds and a *Rendezvous with the Good Old Days* rather than the "subordination of the equity risk premium" suggested by the popularized *New Normal* hypothesis.

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